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IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

CITIZENS BANK OF CLOVIS; JEFF JACOBS; LYNELL G. SKARDA; OSCAR TOLIVER; and T. E. WILLMON, JR.,

PETITIONERS,

v.

WILLIAM E. BROCK, SECRETARY OF THE UNITED STATES DEPARTMENT OF LABOR,

RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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I

QUESTIONS PRESENTED FOR REVIEW

1. Recognizing that today there is some $1.5 trillion invested in ERISA pension funds, can the Federal Courts require that not more than one-third (1/3rd) of a pension fund's assets be invested in any one "type" of investment because of the diversification provision, 29 U.S.C. Sec. 1104(a)(1)(C), of the Employee Retirement Income Security Act of 1974 [ERISA] which states that fiduciaries shall discharge their duties "by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so...." where a "type" of investment may be, but not limited to, any one of the following: (1) United States' bills, notes, and bonds; (2) Insured certificates of deposit in commercial banks; (3) Insured certificates of deposit in a savings bank; (4) Insured deposits in savings and loans;

(5) Common stocks; (6) Preferred stocks; (7) Corporate bonds; (8) Corporate notes; (9) Notes by borrowers of high net worths secured by mortgages on commercial real estate; (10) Insured notes secured by mortgages on residential real estate such as by Government National Mortgage Association [Ginnie Mae], Federal National Mortgage Association [Fannie Mae], and the Veterans Administration [V.A.], (11) State and political subdivision bonds; (12) Mutual and money management funds containing any or a portion of the above?

2. Can the Federal Courts arbitrarily and capriciously, totally absent any Department of Labor [DOL] regulation, abrogate and hold for naught established precepts as to the powers of trustees resulting in most existing ERISA trusts to be in violation of the one-third (1/3rd) "type" of investment limitation ordered in this case and compelling the trustees to so

comply when such compliance in the judgment of pension trustees is neither desirable as a matter of safety or income or common commercial sense?

3. Can the Federal Courts or the Department of Labor, or both, substitute their respective determinations as to amount and "type" of investments contrary to the discretion inherent in ERISA pension trustees?

4. Are mortgages on commercial income producing real estate securing notes executed by borrowers with high net worths of the same "type" as mortgages on non-income producing real estate executed by borrowers with no substantial net worth?

5. Whether enjoining The Citizens Bank of Clovis from investing more than one-third (1/3rd) of the assets in one investment or from loaning to its pension plan is ridiculous overkill not dictated by the facts or law and done only as a

bone to the Department of Labor?

6. Is it proper for the federal courts to dispose of this important case casually if not summarily?

II

PARTIES

All parties are named in the caption. Petitioner, Citizens Bank of Clovis, is without subsidiaries or affiliates and is the only subsidiary or affiliate of its parent, CBC, Inc.

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WILLIAM E. BROCK, SECRETARY OF THE UNITED STATES DEPARTMENT OF LABOR,

RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The petitioners respectfully pray that a writ of certiorari issue to review the opinion of the United States Court of Appeals for the Tenth Circuit entered on February 25, 1988.

OFFICIAL AND UNOFFICIAL REPORTS BELOW

The Tenth Circuit opinion appears in 841 F.2d 344 (1988). The trial court's Memorandum Opinion [MO] has not been published. The Appendix hereto contains the orders and opinions.

GROUNDS FOR JURISDICTION

This action was filed by the Secretary of Labor on June 29, 1983, alleging that the defendants Citizens Bank of Clovis and four (4) officers of the bank had committed violations of ERISA, 29 U.S.C. Sec. 1001 et seq. The United States District Court for the District of New Mexico entered its Memorandum Opinion [MO, here in Appendix A-1] on December 20, 1985, and its Order [here in Appendix A-2] also on December 20, 1985. The United States Court of Appeals for the Tenth Circuit entered its Opinion [Cir. Op., here in Appendix A-3] on February 25, 1988. Defendants'

Petition for Rehearing and for Rehearing En Banc was denied on April 14, 1988, [Rehearing, here in Appendix A-4].

The jurisdiction of this Court to review the judgment of the Tenth Circuit is invoked under 28 U.S.C. Sec. 1254(1).

STATUTES INVOLVED

The Employee Retirement Income Security Act of 1974 [ERISA], 29 U.S.C. Sec. 1001 et seq., and particularly 29 U.S.C. Sec. 1104 states:

> "(a) Prudent man standard of care. (1) ... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity

> and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title or title IV." [Emphasis writer's].

STATEMENT OF THE CASE

The principal issue is whether the Department of Labor's determination that the investment of 85% of the pension trust's assets in participations with other trusts in six (6) notes secured by first mortgages on income-producing real estate in three (3) counties in New Mexico with personal liability of obligors of high net worth violated 29 U.S.C. Sec. 1104(a)(1)(C) so as to merit these

petitioners being enjoined "from investing more than one-third of the Citizens Bank of Clovis Pension Plan assets in one investment or type of investment"? [Appendix A-2; Appendix A-1, p.17] [Emphasis writer's]. The simple facts upon which this erroneous, ill-conceived, if not unprecedented, judgment rests follow.

The Citizens Bank of Clovis [CBC] Pension Plan is a defined benefit plan which requires the employer annually, after an actuarial valuation, to contribute amounts, some $100,000 per year, necessary to insure that the benefits can be paid. Contrary to the lower court's MO, the earnings of the Trust have no effect on the benefits. CBC at this time has assets of some $155,000,000 and $18,717,000 in capital, which alone eliminates risk to the plan. Clovis, New Mexico, is a trade center for 145,000 people and is the County Seat of Curry County with a

population of 44,000. The bank today has some $100,994,000 in loans, most of which are in the Clovis area. There are 4 banks in Clovis with a total of $261,917,000 in loans. The Trustees invested intentionally with borrowers of high net worths on a totally secured basis on income-producing commercial real estate with which each trustee was very familiar. The 6 loans originally constituted approximately 85% of the Plan's assets. Because of payoffs, the real estate mortgages on the loans now only constitute about 16.8% of the Plan's now $1,042,117.44 assets which were some $707,000 at time of suit. These loans have not been replaced because there has been no demand for them and because a 227,312 square foot shopping mall was constructed in Clovis, New Mexico.

The loans are as follows: (1) Loan to K. Barnett & Sons on 10/16/84 in the

original amount of $300,000, of which 33 1/3% was from the Plan and the balance from other trusts secured by farm and ranch properties in De Baca and San Miguel Counties, New Mexico, appraised at $550,000 with personal guaranties of the borrowers showing net worths in excess of $4,400,000; (2) Loan to Robert C. and Julia Taylor on 1/24/78 in the original amount of $90,000, of which 50% was from the Plan secured by an office building in northeast Clovis with an appraised value of $158,250, with Taylors' net worth being $224,000; (3) Loan to Wilbur P. and Joanne M. Johnson and Donald R. and Anna Gustenia Bonner dated 4/19/71 in the original amount of $300,000, of which 8 1/3% was from the Plan secured by a mortgage on a Furr Food Super Market building in downtown Clovis appraised at $470,000, with a personal liability of the borrowers having a combined net worth of $8,000,000; (4) Loan to Barney

J. Bocock and wife, Richard Petty and wife, David Petty and wife, and Armand Smith and wife, on 1/4/79 in the original amount of $215,000 on a cold and dry storage building in northeast Clovis appraised at $287,800, all of which was from the funds of the Plan, with the four borrowers having a combined net worth in excess of $5,000,000; (5) Loan to Delvin D. Schutes, Roy Franse, and LeRoy Hunton dated 5/22/79 in the original amount of $120,000, of which 50% was from the Plan, on a restaurant building in west central Clovis appraised at $184,400, with the borrowers having a combined net worth in excess of $1,000,000; (6) Loan to Bottlers, Inc. dated 3/3/81 in the original amount of $216,000, of which 50% came from the Plan, on two apartments in northwest Clovis appraised at $425,000, with the guarantors having a net worth in excess of $5,000,000. All of these loans were adequately secured by mortgages and

the personal guaranties of the borrowers and individuals. In fact, the trial court in its Memorandum Opinion found that the loans were "prudent". There has never been a delinquency nor a loss resulting to the Plan from these commercial real estate loans even since 1958 when CBC set up its original pension plan which came under ERISA in 1974.

THE REASONS FOR GRANTING THE WRIT

I

> Neither the Federal courts, nor the Department of Labor [DOL], or both, absent a valid DOL regulation, can order the trustees of $1.5 trillion of ERISA pension funds to place not more than one-third (1/3rd) of a fund's assets in any one "type" of investment.

This is believed to be a case of first impression in this Court, if not all courts. If the lower courts' decisions stand, the effect on $1.5 trillion of ERISA pension funds, not just petitioners' fund,

will be awesome as trustees will have to adjust most of their investments to comply with the not more than one-third (1/3rd) rule. To do so is commercial idiocy - a result that the petitioners were unable to get the Tenth Circuit to comprehend. Further, there is no basis for such a result in either the statute, 29 U.S.C. Sec. 1104(a)(1)(C), the House Conference Report, P.L. 93-406, No. 93-1280 reprinted in United States Code Congressional and Administrative News, 93rd Congress - Second Session 1974, p.5084 [Report], or basic trust law. The pertinent part of 29 U.S.C. Sec. 1104(a)(1)(C) says fiducaries shall discharge their duties:

> "by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so...."

This statute does not imply any percentage for diversification, but only to minimize

large losses in the first instance and not diversify at all if prudent.

The conference Report, supra, is considered the bible of the ERISA religion stating:

> "Diversification requirement. --The substitute requires fiduciaries to diversify plan assets to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. It is not intended that a more stringent standard of prudence be established with the use of the term 'clearly prudent.' Instead, by using this term it is intended that in an action for plan losses based on breach of the diversification requirement, the plaintiff's initial burden will be to demonstrate that there has been a failure to diversify. The defendant then is to have the burden of demonstrating that this failure to diversify was prudent. The substitute places these relative burdens on the parties in this matter, because the basic policy is to require diversification, and if diversification on its face does not exist, then the burden of justifying failure to follow this

general policy should be on the fiduciary who engages in this conduct.

The degree of investment concentration that would violate this requirement to diversify cannot be stated as a fixed percentage, because a prudent fiduciary must consider the facts and circumstances of each case. The factors to be considered include (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) the dates of maturity.

A fiduciary usually should not invest the whole or an unreasonably large proportion of the trust property in a single security. Ordinarily the fiduciary should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. Thus, although the fiduciary may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the plan assets in

> the shares of corporations engaged in a particular industry. If he is investing in mortgages on real property he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property so that a decline in property values in that district or of that class might cause a large loss.
>
> ***
>
> The conferees intend that, in general, whether the plan assets are sufficiently diversified is to be determined by examining the ultimate investment of the plan assets. For example, the conferees understand that for efficiency and economy plans may invest all their assets in a single bank or other pooled investment fund...." [Emphasis writer's].

The Report states quite clearly that the degree of investment concentration required for diversification "cannot be stated as a fixed percentage" because a prudent fiduciary must consider "the facts and circumstances of each case". The trial court's Memorandum Opinion [MO] left out of his quote the no fixed percentage

verbiage of the Report. Notwithstanding the Report's admonition, the trial court proceeded to enjoin investment of more than one-third (1/3rd) of the plan's assets in "one investment or type of investment." MO, Appendix A-1, p.17; Order, Appendix A-2. There was no issue as to "one investment" in this case, i.e., concentration of credit in one borrower. Just why the "one investment" verbiage got in the MO is a mystery as is how those words survived the Tenth Circuit's scrutiny. All of which leads petitioners to believe that there is more than the usual confusion in deciding this simple case.

The Report tracts almost verbatim Restatement (Second) of Trusts [Res. T.2d], Sec. 228, Comment a., as to diversifying so as to minimize the risk of large losses, and Comment b. as to the seven (7) factors, among others, that a fiduciary should consider in making a diversification of

investments, to-wit: (1) trust's purpose; (2) amount of assets; (3) financial and industrial conditions; (4) type of investment; (5) geographical distribution; (6) industry distribution; (7) maturity date. Appendix A-5. It is impossible to rationalize a one-third (1/3rd) allocation among investments when the fiduciary has to consider all of these factors. In fact the Report, p.5076, supra, says: "The labor law provisions apply rules and remedies similar to those under traditional trust law to govern the conduct of fiduciaries." Even the Tenth Circuit has previously concluded that the principles of traditional trust law apply to ERISA. Eaves. v. Penn, 587 F.2d 453 (Cir. 10, 1978). But the Tenth Circuit refused to follow or even discuss its own precedent.

Traditional trust law on a trustee's discretionary powers completely negatives the result in the instant case. The Res.

T.2d, Sec. 187, Comment e., puts to rest the courts' lack of power, and it is thought also that of the DOL, to substitute their discretion for that of the trustees, where it reads:

> "The mere fact that if the discretion had been conferred upon the court, the court would have exercised the power differently, is not sufficient reason for interfering with the exercise of the power by the trustee."

Limiting types of investment to one-third (1/3rd) of the total is unheard of. It is wrong on reason and wrong on fact.

The Report, p.5085, supra, contemplates that all or nearly all of a pension fund can be in one type of asset. It says that "ordinarily" the fiduciary "should not invest the whole or an unduly large proportion of the trust property in one type of security...." But then the report goes on to say that "although the fiduciary may be authorized to invest in industrial

stocks, he should not invest a disproportionate amount of the plan assets in the shares of corporations engaged in a particular industry." This is a direct quote from Comment e., of Res. T.2d, Sec. 228. Similarly the Report, supra, says that "If he is investing in mortgages on real property he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property...." which is almost a direct quote from Res. T.2d, Sec. 228, Comment e.

The fact is that most pension plans keep their assets largely invested in common stocks even after the stock market crash of October 19, 1987. This the plan can do whether individually directed by the trustee or in a pooled investment fund. Report, p.5085, supra. An uproar would surely result were this long established practice clearly authorized be changed.

Some trustees warm to common stocks. The petitioners here are opposite, i.e., they want secured investments in mortgages executed by borrowers who could pay regardless of the value of the realty. On balance, petitioners have to be commercially correct. But one thing is certain, you cannot countenance one policy for common stocks unsecured and a different policy for trustees requiring secured investments on commercial realty by borrowers of high net worth.

The intention of the Congress was clearly stated at the outset in Report, p.5075, supra, when the conference report wrote:

> "... that plan assets generally are to be held in trust, and that trustees generally are to have the <u>exclusive</u> <u>authority</u> to manage and control plan assets." [Emphasis writer's].

This agrees with the statute and traditional trust law. There is no difference.

If the DOL thinks otherwise, it can try to notice a regulation under its power given in 29 U.S.C. Sec. 1135. This the DOL has not even attempted to do nor is it likely to because to set a percentage on types of investment would be contrary to every principle of ERISA, Congress' intention, and traditional trust law.

This is an embarrassing overreaching by both the Tenth Circuit and the DOL. The magnitude of the decision if applied to the $1.5 trillion of pension fund assets is staggering. Petitioners plead not for just their little pension fund, but for all pension funds.

II

Diversification within "type" is all that is required by ERISA, Congress' intention, or traditional trust law.

Strangely, ERISA does not define either "diversification" or "type" of investment. Neither has the DOL attempted

to do so, assuming such definitions could be validly promulgated after notice and hearing. The word "type" appears only in the Report, p.5085, stating that diversification is had if diversified within one type. That is, you can have all in stocks if there is not a disproportionate amount in stocks of a "particular industry" or mortgages if not in a particular "district" or upon a "particular class" of property. As stated in Point I, this tracks Res. T.2d, Sec. 228, Comment e. ERISA is merely a loose, if not unfortunately abbreviated, Restatement of Trusts Second. So one has to look to Res. T.2d to fill the voids in ERISA and the Report. While Sec. 228 of Res. T.2d is fairly clear standing alone, it is expanded in Sec. 227, on investments, where Comment o. states:

> "Although trustees may properly invest in a <u>particular type of security</u>, a trustee must use care and skill and caution in

> selecting an investment
> within the type."
> [Emphasis writer's].

Then follows ten (10) factors for trustees to consider in selecting investments not unlike those in Res. T.2d, Sec. 228, Comment b., heretofore cited. This is expanded on in Res. T.2d, Sec. 227, Comment f., reading:

> "Kinds of investments.
> Ordinarily it is proper
> for a trustee to invest
> in government securities,
> such as bonds of the
> United States, or of
> the State or of the
> municipalities, in
> first mortgages on land,
> or in corporate bonds.
> In any case, however,
> whether the investment
> is proper depends upon
> the circumstances. Such
> investments are not proper
> if under all the circum-
> stances they are not
> prudent investments.
> See Comment o."
> [Emphasis writer's].

The trial court found that petitioners' investments were prudent. If prudent, they were necessarily proper. One cannot

rationally have prudent investments which are imprudent because not diversified.

It should be obvious that authorization to invest in industrial stocks is limited only by not investing too large amount in stocks of a particular industry, so one could have the whole trust fund in common stocks, and many trust funds do that. Such being the case, industrial stocks are not "one type of security" and neither are mortgages on realty "one type of security." The other way around is to say that if industrial stocks or mortgages are one type of security, then diversification within one type is all that is required. The Report and Res. T.2d clearly indicate that at the most diversification within one type is all that is necessary.

The issue here then is not that petitioners secured their investments with mortgages on real estate. The issue is what was the class of property in the

mortgages and whether the net worths of the borrowers distinguished these loans from those where the collateral was the only significant security. These mortgaged properties were all of a different class, i.e., (1) Farm and ranch properties in two (2) other counties; (2) Office building in northeast Clovis; (3) Supermarket building in downtown Clovis; (4) Cold and dry storage building in northeast Clovis; (5) Restaurant building in west central Clovis; (6) Two apartments in northwest Clovis. These properties are not identical and neither are the borrowers. The loans were simply not of the same "type", and no amount of convoluted reasoning can make them the same "type".

The high net worths of the borrowers made these loans prudent had they been unsecured. The petitioners viewed the commercial mortgages as merely additional security for a loan which if unsecured

would have been prudent. Res. T.2d, Sec. 227, Comment i., states:

> "An unsecured loan of trust funds may be improper because imprudent. Such a loss, however, is not necessarily imprudent."

It is manifestly erroneous to say that by taking mortgages on different types of commercial realty as additional security, the petitioners limited the total amount of loans of this type which they could make when petitioners could have put it all in the stock market or corporate bonds of different companies totally unsecured.

An investment in common stocks, corporate bonds, or the like, being unsecured compels the investor to rely solely on the corporate borrower's net worth, i.e., capital, with the hope that payment will first come out of earnings. Clearly, the personal guaranties of petitioners' high net worth borrowers have exactly the same financial result as relying on a corporation's

capital or earnings. To reason that these loans are not prudent and diversified, the courts will have to say that as a matter of law petitioners cannot make loans to non-corporate and non-national borrowers on the same basis as made to corporate and national corporations despite the fact that the non-corporate and non-national borrowers have secured the loans with mortgages on various commercial income producing properties while the national corporations have no security at all.

The lower courts' lack of reasoning stems from an obvious failure to understand admitted and uncontroverted facts as applied to the commercial world. The trial court stated that the loans were secured by realty in a single geographic area, and in the event of a severe economic downturn in the area, repayment might be affected and the value of the realty might decline. This shows that the court completely mistook or ignored

the basis upon which these loans were made. These loans would not have been made or even considered by petitioners had they been looking for payment solely from the real property collateral. Economies may go up and down, but it is most irrational to suggest that these substantial net worths of the borrowers would be wiped out.

Even without net worths, Res. T.2d, Sec. 228, Comment e., does not prohibit investing all in mortgages so long as a disproportionate amount is not in a particular district or class of property. There is no question but that the secured properties were of different classes as shown above. Neither were they in the same district. Clovis, New Mexico has districts the same as any other city and their differences are just as great as in any larger city. Certainly a farm 63 miles away and development ranch land 168 miles away are not in the same district. All

cities, small, medium, and large, have districts of varying size, location, and economic vitality. The people from city to city equally vary, and they are as important as the industries. Geographic location is a minor consideration at best and its principal thrust is to prevent concentration of credit in a single borrower. For example, if petitioners loaned 85% of their plan's assets to International Business Machines (I.B.M.) which had locations in twenty (20) cities, do you have geographic diversification? Of course not! Can anyone seriously contend that if petitioners make a mortgage loan in New Mexico, the next mortgage loan has to be in Texas [heaven forbid poor Texas] or somewhere else because of geography? Nothing in the decided case law implies such.

The fact that petitioners' borrowers had extraordinary large net worths differentiate these mortgage secured loans entirely from

the imagined geographic diversification problem as a matter of law and of common sense. The fact that the borrowers' net worths were diversified alone eliminated any nebulous requirement about geography. To a large degree geographic diversification implies that the sale of the collateral securing a loan is the only way to get paid, i.e., the other financial resources of the borrowers are not relied on. This would be the case in uninsured residential mortgage lending. But it is not the case of mortgages on income producing real estate where the borrowers have net worths far in excess of their mortgage debts. It is suggested that the minimal risk mortgages petitioners were able to get completely set them apart from any other analogous lending. Petitioners felt that it was common sense. The lower courts said in effect that a mortgage is a mortgage, period. Almost anyone with a modicum

of commercial sense knows that is not true.

To say in the first place that this kind of ultra-safe mortgage lending is not diversified as to type or class or geography belies rational conclusions. Further to say that you cannot have more than one-third (1/3rd) in mortgages on income producing commercial properties of different classes guaranteed by individuals of high net worth is contrary to ERISA, the intention of Congress, and basic trust law. Compelling petitioners to invest contrary to their best and proven judgment is an exercise of judicial interference far exceeding that given by law.

If the petitioners are wrong, then the courts and the DOL are assuming a responsibility unprecedented in the law of ERISA and of trusts, and a responsibility which bank trust regulators, who deal with this subject more than anyone

else, would not dream of undertaking. If there should be such a power, it is one to be exercised sparingly and only under the most aggravated circumstances which do not exist in the instant case. A court will really have to strain to punch holes in thirty (30) years of this pension fund. The lack of guidelines from this Court dictates that it grant certiorari if not to protect petitioners, then to protect the other $1.5 trillion of pension funds that will have to comply with this absurd result.

III

Enjoining petitioners from having more than one-third (1/3rd) in any one investment or type of investment is ridiculous overkill not merited by the law or facts.

This suit commenced primarily for the purpose of requiring petitioners to not invest more than thirty percentum (30%) of the pension fund's assets in real estate

mortgages, whether commercial or residential. Without any evidence to support it the matter has evolved into an injunction prohibiting petitioners "from investing more than one-third (1/3rd) of the Citizens Bank of Clovis Pension Plan assets in one investment or type of investment." The real estate mortgage limitation just disappeared. We now have the one-third (1/3rd) limitation applying to any type of investment. Petitioners would violate such an injunction by putting more than one-third (1/3rd) in United States treasury bills, notes, or bonds, or even F.D.I.C. insured certificates of deposit, or just plain interest yielding bank accounts. This was not an issue at trial. Nowhere is there any statement or evidence that petitioners would not follow a final court's determination as to the applicable law. Nowhere does it appear or can be implied that The Citizens Bank or its

officers would knowingly violate any law of the United States, regulation thereunder, or of the States. Why then is this impossible injunction necessary as its use is contrary to every principle of Federal process?

There is nothing mandatory about 29 U.S.C. Sec. 1132(a)(5) authorizing the DOL to bring an action to enjoin "any act or practice which violates" ERISA. Donovan v. Robbins, 99 F.R.D. 593 (N.D. Ill., E.D., 1983). Rather, the traditional equitable considerations are pertinent to the determination whether permanent injunctive relief should be imposed in a particular case. Hecht Co. v. Bowles, 321 U.S. 321, 64 S.Ct. 587, 88 L.Ed. 754 (1944). Justice Douglas said in Hecht Co. v. Bowles, supra:

> "The historic injunctive process was designed to deter, not to punish.... Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made

> equity the instrument of nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims."

All that this relatively small pension trust has done is make money. The amount of money it makes only affects the amount of money the bank has to contribute to it as it is a defined benefit plan. We are talking about dollars. Dollars do not constitute irreparable injury as there is an adequate remedy at law. The bank with $18,717,000 of capital can pay $100,000 per year. If the plan loses money, the bank has to replace it. Today there is only 16.8% of the plan's assets in these commercial mortgages and well below the one-third (1/3rd) threshold. In fact, petitioners believe this issue is moot. Just why the Tenth Circuit wants to strain to enjoin, of all things, a moot issue is hard to understand.

This case should be disposed of by declaratory judgment. In 7 Moore's Federal Practice, Par. 65.18[2], p.65-171, this suggestion is as follows:

> "The injunctive remedy may serve two purposes: (1) that of a provisional or final remedy; (2) as a declaration of rights.
>
> ***
>
> Insofar as injunctive relief is sought solely for the second purpose - a declaration of rights - the declaratory judgment is an adequate substitute. It may be had whether or not further relief is or could be demanded; and the existence of another remedy does not preclude a judgment for declaratory relief in cases where it is appropriate. Where further relief is necessary or proper this may be had, including injunctive relief, by way of supplemental proceedings."

As shown previously, this case does not merit injunctive process in the first instance. This disagreement is over a pure question of law as the facts are not controverted and never have been. From

whatever aspect this case is viewed, injunction is not merited. It is equally not merited as to loans to the pension plan. It is analogous to enjoining a person from committing an act of negligence or a crime. Such is ridiculous overkill.

IV

This important case has received casual and summary treatment in both the trial court and the Tenth Circuit.

This case went to trial without a jury before Judge Bobby R. Baldock, who was appointed June 7, 1983, as District Judge for the District of New Mexico. The trial commenced on June 17, 1985, requiring two (2) days. The trial court's Memorandum Opinion was entered December 20, 1985, some 186 days later, an extraordinary passage of time for a trial court's decision. Judge Baldock entered his Tenth Circuit appointment on December 17, 1985. Between the

trial and the Memorandum Opinion, Judge Baldock was involved in confirmation hearings giving what is obviously passing attention to this cause.

The primary issue was diversification with minor issues of the bank loaning to the pension fund pending maturity of the fund's investments, and the fund placing permanent financing on buildings constructed with bank interim financing. The DOL prevailed on diversification and loaning to the plan without reimbursing the plan on the latter, and the bank effectively prevailed on the remaining issues.

At time of trial, the plan had 21% of its assets in these commercial realty mortgages and contended the diversification issue was moot. Today the percentage is 16.8%. The court found that it was not moot because petitioners "have offered no assurance that they

will not resume concentrating the plan's assets in local real estate mortgages; to the contrary, defendants insist on a free hand in selecting investments for the plan. Given the potential for recurrence, the controversy regarding diversification is not moot. Donovan v. Cunningham, 716 F.2d 1455, 1461-62 (5th Cir. 1983)." Petitioners have a basic constitutional right to litigate to the highest court their firm conclusion that their views on the law are correct. By doing so, no court could conclude that they would not comply with the final determination of the law. An injunction is not dictated when the law is found to be different than that relied on by parties in any lawsuit. If otherwise, every lawsuit would end with an injunction. The result here is unreasonable. This is simply an hallucination on the part of the trial court. Petitioners

feel very strongly that they are right on the law of diversification applied to the facts of this case which is why they are here. Nowhere at any time have petitioners ever implied that they would refuse to follow the law were it determined to be contrary to petitioners' conclusions, nor have they been asked. To even contemplate that petitioners would intentionally violate a court holding is not only unbelievable but flies in the face of the law of evidence. Noncompliance or nonobservance of the law will not be presumed, rather, the presumption is that petitioners will follow the law. 29 Am.Jur.2d, Evidence, Sec. 168, p.208; 31A C.J.S., Evidence, Sec. 134, p.275. Federal Rule of Evidence 301 imposes on the DOL the burden of going forward with the evidence to rebut or meet the presumption of compliance or observance. No such evidence appears in this case. The court's conclusions have no basis in fact or law.

The trial court then gets involved in an indigenous discussion of matters not raised in the pleadings or the trial such as: (1) "non-systematic risk and systematic risk"; (2) "default risk"; (3) "spread or interest rate risk"; (4) "inflation or purchasing power risk"; (5) "risk that rate of return would decline due to inflation"; (6) "not liquid"; (7) "no secondary market"; (8) "difficult to switch out of mortgages and take advantage of other opportunities"; (9) "modern finance theory". Where on earth did the trial court come up with these non-issue comments? These risks are present in every investment including U. S. Treasury securities and F.D.I.C. insured certificates of deposit. Petitioners have had no opportunity to contest these non-issue and non-evidence arguments. Investment advisers are almost as numerous as lawyers.

There is little agreement between such advisers. None are situate as these petitioners with highly specialized knowledge of their investments in different classes of commercial real estate mortgages.

This was a defined benefit plan under 29 U.S.C. Sec. 1002(35) where the retirement benefits are computed by an actuary each year, and the bank has to make up the difference so as to keep the plan fully funded at all times. Earnings of the plan present a problem only to the bank because if it does not like the performance of the trustees, the bank can terminate them and get others. Inflation is immaterial as the beneficiaries get only a sum certain. Interest rate risk is similarly not a factor. Secondary market sale is not a factor because the investments were made to keep. Modern finance theory is equally irrelevant

because the trustees opted for safety rather than maximum yield. One can assume that all of these indigenous trial court non-evidence theories were the basis for the court's erroneous decision on diversification. Tangential thoughts of this kind cannot properly be considered outside the evidence.

In fact today commercial real estate mortgages are not bundled and sold as units like residential mortgages. A fortiori, petitioners believe that their commercial mortgage lending only to borrowers or guarantors of exceptionally high net worth totally distinguishes these investments from any others. Geographic concentration is not a factor here. Blind adherence to mortgages generally as a "type" while ignoring the different "classes" within "types" is not the real thrust of trust law diversification. Had the trial court spent as much time in

reading Res. T.2d as he did in trying to give petitioners a business school lesson, the result would be different.

Petitioners did their best to inform the Tenth Circuit of the trial court's failings. Notwithstanding, the Tenth Circuit categorized the trial court's Memorandum Opinion as being "flawless". There never has been a flawless judicial memorandum. Some are just better or worse than others. The Tenth Circuit gave only passing attention to the significant issue of diversification. The lack of analysis of this major issue of first impression in that Circuit indicates that petitioners have received only casual and summary consideration of this extremely important issue of diversification under ERISA. You cannot brush off the issue of diversification in four (4) lines of text and contend that you have given substantial treatment to these petitioners. Such treatment is not like

the diligent and thorough analysis usually dispensed by the Tenth Circuit. Neither does the pressure of a backlog of cases justify this minimal consideration.

Petitioners filed what they thought was a well reasoned and compelling Petition For Rehearing and For Rehearing En Banc on March 25, 1988. This was too rapidly denied on April 14, 1988. Appendix A-4.

This is a major case on ERISA and merits a thorough and detailed judging. This it has not received. At the least, this case under these exceptional circumstances should be remanded for retrial if a petition for certiorari be deemed inappropriate.

CONCLUSION

For the above reasons, it is respectfully submitted that this petition for a writ of certiorari be granted so that the judgment and decision of the

United States Court of Appeals for the Tenth Circuit be reviewed.

Respectfully submitted,

SPANN, LATIMER & HOLLOWWA
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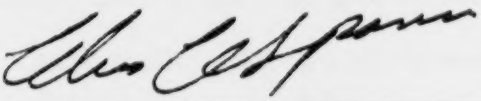
By: 

CHARLES C. SPANN

IN THE DISTRICT COURT OF THE UNITED STATES

FOR THE DISTRICT OF NEW MEXICO

FILED
UNITED STATES DISTRICT COURT
ALBUQUERQUE, NEW MEXICO
DEC 20 1985
s/s Jesse Casaus, Clerk
ENTERED ON DOCKET
DEC 20 1985

WILLIAM E. BROCK,
Secretary of the
United States
Department of
Labor,

Plaintiff,

vs. CIV 83-1054 BB

CITIZENS BANK OF
CLOVIS, JEFF JACOBS,
LYNELL G. SKARDA,
OSCAR TOLIVER and
T. E. WILLMON, JR.,

Defendants.

MEMORANDUM OPINION

THIS MATTER came on for trial on June 17, 1985, and the court, having considered the testimony, exhibits and other relevant law, now issues its decision in accordance with Rule 52 of the Federal

Rules of Civil Procedure. The Secretary of Labor sued the Citizens Bank of Clovis and the defendant trustees of the bank's employee benefit plan. Defendant trustees are also officers and directors of the bank. The Secretary seeks to enforce the diversification requirements and the prohibition against party in interest transactions in ERISA.

The Citizens Bank of Clovis Pension Plan was established for the bank's employees in 1958. It is a defined benefit plan which requires the bank to contribute needed amounts to maintain the plan in sound actuarial condition so as to provide set benefits, as opposed to a defined contribution plan which provides benefits based on the amount contributed and plan performance. 29 U.S.C. Sec. 1002(34) and (35). The plan is subject to the requirements of the Employment Retirement and Income Security Act (ERISA), and whether

the trustees have complied with that Act's provisions concerning investment decisions is at issue.

When this controversy arose, some 81.93 percent of total plan assets of $707,000 was invested in first mortgages secured by commercial property primarily located in Curry County, New Mexico. By July, 1983, the concentration of plan assets in real estate mortgages was reduced to 65.7 percent and, by the time of trial, further reduced to 21 percent of plan assets. On four occasions, the bank made short-term loans to the plan to enable the plan to participate in certain mortgages. The bank earned $5,675.90 in interest from the plan on these loans. On two occasions the plan provided permament financing where the bank had provided interim financing.

The Secretary suggests that the heavy concentration in real estate

mortgage loans runs contrary to the diversification provisions contained in title 29 U.S.C. Sec. 1104(a)(1)(C). He also argues that the lending transaction between the bank and the plan violated 29 U.S.C. Sec. 1106(a)(1)(B) which prohibits lending of money between the plan and a party in interest. Finally, the Secretary contends that the plan's providing permanent financing where the bank had provided interim financing represents self-dealing prohibited by title 29 U.S.C. Secs. 1104(a)(1), 1106(a)(1)(D), 1106(b)(1) and (2). After lengthy consideration, under the facts of this case, I agree with the Secretary regarding the plan's lack of diversification and the lending transactions between the bank and the plan. I cannot agree that the plan's providing permanent financing violated the above statutory provisions because of inadequate proof by the Secretary.

A. Diversification

Before addressing the diversification issue, it is necessary to consider two preliminary arguments of defendants. They first contend that the diversification issue is now moot because the plan has reduced its concentration of real estate mortgages to well below 30 percent, the figure proposed administratively by the Secretary and rejected by the defendants. But defendants have offered no assurance that they will not resume concentrating the plan's assets in local real estate mortgages; to the contrary, defendants insist on a free hand in selecting investments for the plan. Given the potential for recurrence, the controversy regarding diversification is not moot. Donovan v. Cunningham, 716 F.2d 1455, 1461-62 (5th Cir. 1983).

Defendants next contend that the diversification provision, while appli-

cable to defined contribution plans, should not apply to a defined benefit plan because any losses to the plan must be covered by the bank to assure that defined benefits will be available to plan participants. Neither the language of the statute nor the legislative history suggest such a distinction. 29 U.S.C. Sec. 1104(a)(1)(C); H.R. Rep. No. 1280, 93rd Cong. 2d Sess., reprinted in U.S. Code Cong. & Admin. News 5038, 5081-85 (1974). I recognize that there is some interpretive authority supporting the idea that diversification requirements will be influenced not only by trust elements but also by the specific features of particular plan including whether the plan is a defined benefit or defined contribution plan. L. Kearns, Rules of Diversification Under ERISA, 115 Trusts & Estates 736, 736-38 (1976).

The approach taken to diversification

has ranged from "put all your eggs in one basket and watch the basket," In re Adriance's Estate, 260 N.Y.S. 173, 181, 159 Misc. 345 (1932) (attributed to Andrew Carnegie) to applying efficient markets theory which recognizes that risk is divisible into non-systematic risk which is diversifiable and systematic risk which is not, J. Langbein & R. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887. See also J. Walters, An Overview of Fiduciary Law, contained in The Investment Manager's Handbook, 571-75 (S. Levine ed. 1980). The relevant provision of ERISA (29 U.S.C. Sec. 1104) provides:

> (a)(1) ... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -
>
> ...
>
> (C) by diversifying investments of the plan so as to

> minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

The diversification provision in large part tracks section 228 of the Restatement (Second) of Trusts (1959) which provides:

> Except as otherwise provided by the terms of the trust, the trustee is under a duty to distribute the risk of loss by reasonable diversification of investment, unless under the circumstances it is prudent not to do so.

Thus, the diversification provision in ERISA originated in the law of trusts. Eaves v. Penn, 587 F.2d 453, 457 (10th Cir. 1978).

The purpose of diversification is to "distribute the risks of loss in order to maintain the trust principal, usually by limiting the proportion of total trust assets invested in any one stock or class of securities." G. Bogert, The Law of

Trusts & Trustees Sec. 612 at 18) (Rev. 2d ed. 1980). Accordingly, a reasonably prudent trustee will consider diversification. Id. By spreading asset purchases throughout a number of varying types of securities or investments, a trustee, to some extent, may protect against adverse business conditions, imprudence, or dishonesty in a particular field and minimize the risk of large losses. Id; 3 A. Scott, The Law of Trusts Sec. 228 at 1855 (3rd ed. 1967). Conversely, the trustee ordinarily should not "invest more than a reasonable proportion of the trust estate in a single security, or it would seem, in a singly type of security." 3 A. Scott, The Law of Trusts Sec. 228 at 1855 (3rd ed. 1967).

When the Secretary brings an action for non-diversification, the Secretary initially must prove a lack of diversification. That done, the burden is on the

defendant to prove that non-diversification was prudent, H. Rep. No. 1280, U.S. Code Cong. & Admin. News at 5084 (1974); Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F.Supp. 378, 384 (D. Hawaii 1980).

The committee report on the diversification provision makes clear that the basic policy is one of diversification. It provides:

> A fiduciary usually should not invest the whole or an unreasonably large proportion of the trust property in a single security. Ordinarily the fiduciary should not invest the whole or any unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. Thus, although the fiduciary may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the plan assets in the shares of corporations engaged in a

> particular industry. If he is investing in mortgages on real property he should not invest a disproportionate amount of the trust in mortgages in a particular district or on a particular class of property so that a decline in property values in that district or of that class might cause a large loss.

H. Rep. No. 1280, U.S. Code Cong. & Admin. News at 5085 (1974). The above passage incorporates comment e of Sec. 228 of the Restatement (Second) of Trusts (1959). The committee report also incorporated comment b of the Restatement which lists seven factors to be considered in making a diversification of investments.

The degree of concentration in any asset or in any particular type of asset which would violate ERISA is determined on an ad hoc basis. In Donovan v. Guaranty Nat'l Bank, 4 Empl. Ben. Cas. 1686, 1691 (S.D.W. Va.) the trial court determined that a plan which invested all plan assets in residential real estate

mortgages in a single geographic area was not diversified. The plan had suffered a loss due to a foreclosure and, according to the court, had not kept pace with the trend of rising interest rates by investing in long term, fixed interest rate mortgages in a single geographic area. The plan's trustees and the employer bank were enjoined from acquiring additional mortgages until the plan's percentage of mortgages dropped to less than one-third of all plan assets. Further, only a third of a plan's assets were to be placed in any particular class of investments.

The present controversy centers on six loan participations by the bank's plan. The information on the loans was introduced at trial and is contained in an appendix. The majority of the funds in the plan were invested in these loan participations. The evidence supports

that each loan was prudent; however, that is not dispositive of the diversification inquiry.

Throughout the litigation, defendants have maintained earnestly that the plan's investment in real estate mortgages was without risk. This idea must be rejected. There are three types of risks associated with mortgages - default risk, spread or interest rate risk, and inflation or purchasing power risk. J. Fisher, Portfolio Construction: Real Estate, contained in, Managing Investment Portfolios: A Dynamic Process 437, 455 (J. Maginn & D. Tuttle eds. 1983). Default risk is the risk that payments will not be made timely or that it will be necessary to foreclose on the mortgaged property for repayment of the loan. Id. at 455 n. 4. Spread or interest rate risk is the risk that the lender's cost of funds will approach or exceed the interest rate charged to the

borrower. Id. at 455-56 n. 4. Finally, inflation or purchasing power risk is that the expected real rate of return on a mortgage will not be realized because of unanticipated inflation. Id.

At a minimum, the mortgages held by the plan are subject to default risk, however slight, and inflation or purchasing power risk. The plan has taken steps to minimize default risk by participating with other entities in the loans, by loaning less than the estimated value of the properties and by obtaining first mortgages. The plan's mortgage loans, however, are primarily secured by real property concentrated in a single geographic area. In the event of a severe economic downturn in that area, repayment of the loans might be affected and the value of the security backing those loans might also decline. This is precisely the risk at which diversification in its most

elementary form seeks to minimize.

The mortgage loans held by the plan were intermediate term and certainly subject to the risk that the anticipated real rate of return would decline due to inflation. By their nature, these fixed rate loans would not respond to upward changes in interest rates. Nor do they appear to be very liquid given their duration and the lack of an established secondary market for such unique loans. In the event better investment opportunities became available, it might be difficult to switch out of real estate mortgages and take advantage of these opportunities. Some flexibility should be maintained even though it may mean that long-term high rates are not locked in for the entire investment portfolio.

From the foregoing, the concept of diversification is supported by the statute as well as the law of trusts. It is

also supported by modern finance theory. See, e.g., F. Reilly, Investment Analysis & Portfolio Management, 194 (1979); E. Elton & M. Gruber, Modern Portfolio Theory 36-38 (2d ed. 1984). I find that defendants' heavy concentration in real estate mortgages in a limited geographic area constituted a lack of diversification and defendants have not convinced me that a lack of diversification was prudent.

On that note, comment c to section 228 of the Restatement (Second) of Trusts (1959) contains examples of the special circumstances where it might be prudent not to diversify such as where the trust estate is very small or there is general financial instability and government securities are selected. Neither of these circumstances are present here. Moreover, the Secretary established by expert testimony that a suitable universe

of investment assets was available to the plan including real estate, common stock, bonds, U.S. government securities and certain specialized investments.

The selection of plan assets remains the ultimate responsibility of the trustees of the plan. The court becomes concerned with selection only to the extent the Secretary proves that the trustees' selection is contrary to the provisions of ERISA. In this instance the court will enjoin the defendants from investing more than one-third of the plan's assets in one investment or type of investment to effect compliance with the diversification provision of ERISA. 29 U.S.C. Sec. 1104(a)(1)(C).

B. Loans Between the Bank and the Plan

The following loans were made by the bank to the plan:

Date	Amount	Interest Rate	Date Repaid	Interest
1/4/79	$200,000	9.00%	3/1/79	$2,800.00
5/22/79	43,000	9.00	10/3/79	1,440.50
3/5/81	9,000	9.00	4/23/81	110.96
9/16/81	85,000	17.00	10/18/81	1,306.44
				$5,675.90

The Secretary contends that these loans were prohibited by title 29 U.S.C. section 1106(a)(1)(B) which provides:

> A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should known that such transaction constitutes a direct or indirect -
> (B) lending of money or other extension of credit between the plan and a party in interest.

The reported cases relied upon by the Secretary apply to loans from a plan to a party in interest. M & R Investment Co., Inc. v. Fitzsimmons, 685 F.2d 283 (9th Cir. 1982); Donovan v. Bryans, 566 F. Supp. 1258 (E.D. Pa. 1983); Marshall v. Kelly, 465 F. Supp. 341 (W.D. Okla.

1978) Freund v. Marshall & Isley Bank, 485 F. Supp. 629 (W.D. Wis. 1979); see also, Donovan v. Mazzola, 716 F.2d 1226 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984).

The bank as the plan sponsor was a party in interest. 29 U.S.C. Sec. 1002(14)(C). Unlike the cases relied upon by the Secretary, the party in interest (the bank) lent the plan money, not the other way around. The bank lent the plan money so that the plan might take advantage of what the trustees considered favorable investment opportunities in real estate mortgages. The Secretary produced no evidence that the transactions were other than arms-length or that the interest charged was other than reasonable.

Still, I am bound to give the statute its plain and ordinary meaning and it does proscribe lending of money between

the plan and a party in interest. The statute's prohibition is not restricted only to loans from the plan to a party in interest. See H.R. No. 1280, reprinted in U.S. Code Cong. & Admin. News 5088 (1974) (prohibited transaction could occur even if loan to a plan were guaranteed by a party in interest). This conclusion is bolstered by the statutory section of ERISA which provides for the Secretary to grant individual or class administrative exemptions from prohibited transactions. 29 U.S.C. Sec. 1108. Additionally, had the loan to the plan been interest free, there is a class administrative exemption from the prohibition. See 45 Fed. Reg. 28545-46 (1980).

I have considered the statutory exemption for ancillary bank services contained in title 29 U.S.C. section 1108(b)(6)(B) and its potential appli-

cation to the loans made by the bank to the plan. It does not apply. I find that the defendants' knew or should have known that the lending transactions violated title 29 U.S.C. section 1106(a)(1)(B); therefore, I will enjoin the defendants from causing the plan to engage in loan transactions between the plan and a party in interest without a specific administrative exemption.

C. Plan's Providing Permanent Financing

The Secretary also suggests that the plan's retirement of interim construction financing supplied by the bank is contrary to general provisions of ERISA. On loans numbered 1 and 4 contained in the appendix, the bank supplied the interim financing, and the plan supplied the permanent financing. The Secretary has cited a host of provisions claiming violations.

1. Title 29 U.S.C. section

1104(a)(1) requires that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries." The Secretary's position is that the trustees were watching out not only for the plan, but also for the bank, in arranging and making the two permanent loans. The divergence of interests between the interim lender and the permanent lender is termed "self-evident." Plaintiff's Trial Brief filed June 13, 1985 (pleading no. 67). Allegedly, the trustees did not make the loans solely in the interest of the plan participants and beneficiaries, but also considered the bank's interests.

2. Title 29 U.S.C. section 1106(b)(1) provides that "a fiduciary with respect to a plan shall not deal with the assets of the plan in his own interest or for his own account." The

Secretary contends that the bank as plan sponsor fiduciary necessarily lacked complete loyalty to plan participants when it granted interim financing in question (it knew that the plan would supply the permanent financing to retire the interim) and then arranged the permanent financing.

3. Title 29 U.S.C. section 1106(b)(2) provides that "a fiduciary with respect to a plan shall not in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries." The Secretary suggests that the defendant trustees were acting on behalf of a party (the bank) whose interests were adverse to the plan's when the commitments to provide permanent financing were made by the plan.

4. Title U.S.C. section 1106(a)(1)(D) provides that "a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan." The Secretary contends that the plan's assets were transferred to the bank to retire interim financing when the plan supplied the permanent financing.

Essentially, the Secretary is claiming a breach of the duty of loyalty on the part of the defendants. See Restatement (Second) of Trusts Sec. 170 (1959). Yet, the Secretary's contentions on this point after the trial remain speculation and conjecture. The Secretary did not prove that the trustees of the bank failed to act solely on behalf of the participants and beneficiaries of the

plan when the permanent financing transactions occurred. In the absence of evidence, I will not hold as a matter of law that the interests of the interim lender are always adverse to those of the permanent lender.

The Secretary's interpretation of how these permanent loans occurred or the motivation therefor is rejected for lack of adequate proof. Nor can I agree that providing the borrowers in this case with permanent financing constituted a transfer of the plan's assets to the bank merely because the funds would be used to retire the bank's interim loans. Such an interpretation ignores the role of the borrower for whose benefit the loans are made.

Given the disposition of this case, defendants are not entitled to attorney fees and costs pursuant to the Equal Access to Justice Act, title 5 U.S.C.

section 504. The Secretary shall be granted an injunction as discussed above.

DATED this 20th day of December, 1985, at Albuquerque, New Mexico.

s/s Bobby R. Baldock
United States District Judge

Appendix
Citizens Bank of Clovis
Pension Plan Loans

Loan No.	Date of Note	Total Note	Plan Participation
1	1/24/78	$ 90,000	$ 45,000
2	4/19/71	300,000	25,000
3	1/4/79	215,000	215,000
4	5/22/79	120,000	60,000
5	3/3/81	216,000	108,000
6	9/6/83	300,000	100,000

Interest Rate	Maturity[1]	Collateral	Appraised Value[2]
9.50%	11/24/86 Pd. 2/84	Insurance office	$158,250
8.00	10/11/91	Food share complex	470,000
9.50 12.00[3]	1/4/87	Cold and dry storage facility	287,000
10.00	5/22/87	Restaurant	184,400
13.50	3/3/86 Pd. 8/1/83	Apartments	425,000
17.00	11/16/84	Farm and ranch land	500,000

[1] Balloon payment due.

[2] Bank appraisal, not an independent appraisal.

[3] Starting 6/4/83

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FOR THE DISTRICT OF NEW MEXICO

FILED
UNITED STATES DISTRICT COURT
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WILLIAM E. BROCK,
Secretary of the
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CITIZENS BANK OF
CLOVIS, JEFF JACOBS,
LYNELL G. SKARDA,
OSCAR TOLIVER and
T. E. WILLMON, JR.,

Defendants.

O R D E R

THIS MATTER came on for trial on June 17, 1985, and the court entered its Memorandum Opinion on December 20, 1985, containing its findings of fact and conclusions of law.

NOW, THEREFORE, IT IS ORDERED that the defendants are enjoined from investing more than one-third of the Citizens Bank of Clovis Pension Plan assets in one investment or type of investment.

IT IS FURTHER ORDERED that the defendants are enjoined from causing the Citizens Bank of Clovis Pension Plan to engage in loan transactions between the plan and a party in interest including the Citizens Bank of Clovis without an administrative individual or class exemption from 29 U.S.C. Sec. 1106(a)(1)(B).

DATED this 20th day of December, 1985, at Albuquerque, New Mexico.

s/s Bobby R. Baldock
United States District Judge

PUBLISH

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

FILED
United States Court of Appeals
Tenth Circuit
FEB 25 1988
ROBERT L. HOECKER
CLERK

WILLIAM E. BROCK Secretary of the United States Department of Labor,	)	
Plaintiff-Appellee, Cross-Appellant,	)	
vs.	)	Nos. 86-1288 86-1342
CITIZENS BANK OF CLOVIS, JEFF JACOBS, LYNELL G. SKARDA, OSCAR TOLIVER and T. E. WILLMON, JR.,	)	
Defendants-Appellants, Cross-Appellees.	)	

Appeal from the United States
District Court For the
District of New Mexico
D.C. No. 83-1054

Larry D. Newsome (George R. Salem, Robert N. Eccles, and Louis L. Joseph, Washington, D.C.; and William L. Lutz, U.S. Attorney, and Ronald F. Ross, Assistant U.S. Attorney, Albuquerque, New Mexico, with him on the brief), United States Department of Labor, Washington, D.C., for Plaintiff-Appellee, Cross-Appellant.

Charles C. Spann of Spann, Latimer & Hollowwa, Albuquerque, New Mexico, for Defendants-Appellants, Cross-Appellees.

Before MOORE and BARRETT, Circuit Judges, and ANDERSON, District Judge.*

MOORE, Circuit Judge.

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*Honorable Aldon J. Anderson, United States District Judge for the District of Utah, sitting by designation.

This appeal presents several questions applying the Employee Retirement and Income Security Act (ERISA) to specific transactions involving the Citizens Bank of Clovis Pension Plan. The district court held that Citizens Bank of Clovis (Bank) and the trustees of the Bank's plan violated the diversification requirement and the prohibition against party-in-interest transactions contained in ERISA. The defendant Bank and the trustees appeal that decision. The court refused, however, to hold that ERISA's self-dealing prohibition was violated when the trustees invested plan assets in permanent loans to third parties to whom the Bank had provided interim financing. On procedural grounds, the court also refused to require the defendant Bank to restore to the plan the interest it earned from the loans. The plaintiff Secretary appeals the latter two decisions. Our analysis

leads us to conclude the trial court properly resolved all issues, and we affirm.

The plan for employees of the Bank has existed since 1958. In 1982, the Regional Administrator of the Department of Labor notified the trustees that eighty-five percent of the plan assets had been invested in real estate mortgages around Clovis, New Mexico. The Administrator contended these loans were an apparent violation of 29 U.S.C. Sec. 1104(a)(1)(C), which requires diversification of a plan's investments. The Administrator warned the trustees to reduce the plan's investment in real estate to thirty percent of its assets, or legal action might be taken. The trustees responded that all their investments were prudent and properly diversified. Unsatisfied with the response and concerned over other transactions, the Secretary filed this case.

The Secretary's complaint presented three issues to the district court. First, he argued the trustees' alleged investment of over sixty-five percent of the plan's assets in commercial real estate first mortgages violated the diversification requirements of Sec. 1104.[1] Second, the Secretary alleged the trustees violated 29 U.S.C. Sec. 1106(a)(1)(B) when, on behalf of the plan, they borrowed money from the Bank. Third, he contended the trustees violated their fiduciary responsibilities when they made two loans to persons who used the proceeds to pay off previous loans from the Bank. The basic facts surrounding these issues were not in controversy.

I.

The trial court engaged in a lengthy and well-reasoned analysis of diversification and loan issues constituting the appeal brought by the Bank and the trus-

tees. We believe the court's reasoning on these issues was flawless. In short, the trial court concluded the diversification requirement was not met essentially because the trustees had chosen to invest in "one type of security" which did not protect against a multitude of risks. The court further found that the trustees failed to establish the investments were prudent notwithstanding the lack of diversification. Both these conclusions are fully supported in the record, and we adhere to the trial court's analysis.

The district court further found that any loan between the plan and a party in interest is a per se violation of 29 U.S.C. Sec. 1106(a)(1)(B). The trustees contended there was no violation because they did not loan plan assets to the Bank. The court correctly concluded, however, that Sec. 1106 proscribes loans

made by the party in interest to the plan as well as the reverse.

We also agree with the district court that the trustees' reduction of the percentage of outstanding loans by the plan did not moot the issue of diversification. Because the defendants not only refused to assure the district court that they would maintain the reduced level of investments in real estate loans, but also "insist[ed] in a free hand in selecting investments for the plan," the diversification issue persists. Clearly, the issue could arise again, and the district court correctly proceeded to resolve it. Cf. Weinstein v. Bradford, 423 U.S. 147, 149 (1975).

II.

A.

Turning to the Secretary's cross-appeal, we consider whether ERISA trustees are prevented from lending money

to unrelated persons who thereafter use the loan proceeds to pay obligations to a party in interest. Precisely, we must decide whether 29 U.S.C. Sec. 1106 was violated when the trustees approved loans from plan funds which permitted the borrowers to pay off interim financing they had received from the Bank.

We note, initially, there is no specific provision of Sec. 1106 which prohibits a fiduciary from using plan assets for such a transaction. If the violation exists, therefore, it must arise by implication. It is the Secretary's contention that the transaction here implicated both Sec. 1106(a), which proscribes specific transactions between the plan and a party in interest, and Sec. 1106(b), which proscribes transactions between a plan and a fiduciary. He contends the requirement of 29 U.S.C. Sec. 1104 that a fiduciary act solely

for the benefit of the plan is applicable here as well. Notwithstanding his inability to point to any provision of ERISA that specifically prohibits the transaction he complains of here, the Secretary argues the defendants committed a per se violation of the statute. We do not agree.

Alleging the transactions in controversy are inherently suspicious, the Secretary argues around the absence of a specific prohibition in the statute. He states that the public interest in maintaining the integrity of employee retirement plans demands a strict prohibition of any dealings in which doubt may be cast upon the loyalty of the fiduciary. While we do not denigrate the validity of the Secretary's concept of fiduciary responsibility, we are as unwilling as the district court to translate that concept into a per se violation

when Congress has not done so. We agree with the district court that unless the act complained of falls within the specific list of dealings proscribed by Sec. 1106 (or within the sole dealing provision of Sec. 1104(a)(1)), the transaction does not constitute a per se violation of ERISA.

This is not to say the interjection of a third party into an otherwise prohibited transaction will sanitize an illegal dealing. Indeed, Sec. 1106(a)(1) by its own terms applies to sham dealings by proscribing "indirect" transactions. Accordingly, if the Secretary could have proved that the loans to third parties were a sham to avoid application of Sec. 1106(a), the transactions would have been prohibited transfers of plan assets.

B.

The Secretary's attempt to avoid the burden of proving a violation of fiduciary

duty underscores the absence of any specific ERISA provision upon which we can rely to find the transactions complained of constituted per se violations. He attempts to bridge this gap by suggesting that because the trustees were also employees of the Bank, they made the loans to protect their jobs. Hence, he contends the trustees violated Sec. 1106(b) which forbids dealings between the fiduciary and the plan.

The Secretary would like us to presume that the trustees acted for their own benefit simply because they were employees of the Bank. He argues that it was in the best interest of the Bank to have the interim financing paid off; therefore, to please their employer and thus protect their jobs, the trustees approved the third party loans. Nothing but the Secretary's hypothesis supports this argument.

We believe the trial court correctly perceived that the two loans questioned by the Secretary were different from those the court found wanting between the Bank and the plan. Because we cannot find that the two loans constituted per se violations of either Sec. 1104 or Sec. 1106, the trial court properly ruled the Secretary failed to meet his burden of proof. While we do not hold the transactions were free of ERISA violation, we conclude the trial court correctly ruled the trustees' approval of the loans was not a per se violation of the statute.[2]

III.

Finally, the Secretary contends the trustees should be required to return to the plan the amount of interest the plan paid to the Bank for the loans made in violation of 29 U.S.C. Sec. 1106(a)(1)(B) Although the claim for recovery of such

sums was set out in the pretrial order, it was not addressed in the trial court's dispositional memorandum and order. Noting the court's failure to deal with the claim, the Secretary filed a motion pursuant to Fed. R. Civ. P. 59(e) to amend the judgment to include, among other things, an order requiring reimbursement for the loan interest. Without discussing the merits of the motion, the court denied relief on the ground the motion was not timely. While the Secretary argues those merits in this court, he fails to address the reason why his motion was denied in the trial court. Perhaps that failure is due to the correctness of the ruling. Because the Secretary's motion was not filed until thirteen days after entry of the findings of fact and conclusions of law, the trial court correctly denied relief on jurisdictional grounds.

Beliz v. McLeod & Sons Packing Co., 765 F.2d 1317 (5th Cir. 1985); Scott v. Younger, 739 F.2d 1464 (9th Cir. 1984).

AFFIRMED.

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[1] The original investment had been reduced to 65% by the time the complaint was filed.

[2] None of the cases relied upon by the Secretary belie this conclusion. He relies chiefly upon Cutaiar v. Marshall, 590 F.2d 523 (3d Cir. 1979); Gilliam v. Edwards, 492 F. Supp 1255 (D. N.J. 1980); Freund v. Marshall & Ilsley Bank, 485 F. Supp. 629 (W.D. Wis. 1979); and Marshall v. Kelly, 465 F. Supp. 341 (W.D. Okla. 1978). These cases are all distinguishable factually because in each the fiduciary dealt directly with either himself or a party in interest to commit a specifically prohibited act. In none of those cases was it contended a fiduciary committed a per se violation by dealing with a third party.

MARCH TERM - April 14, 1988

Before Honorable William J. Holloway, Jr., Chief Judge, Honorable James E. Barrett, Senior Judge, Honorable Monroe G. McKay, Honorable James K. Logan, Honorable Stephanie K. Seymour, Honorable John P. Moore, Honorable Stephen H. Anderson, Honorable Deanell R. Tacha, Honorable Bobby R. Baldock, Circuit Judges, and Honorable Aldon J. Anderson, District Judge*

WILLIAM E. BROCK, Secretary of the United States Department of Labor,	)	
Plaintiff-Appellee, Cross-Appellant,	)	
vs.	)	Nos. 86-1288 & 86-1342
CITIZENS BANK OF CLOVIS, JEFF JACOBS, LYNELL G. SKARDA, OSCAR TOLIVER and T. E. WILLMON, JR.,	)	
Defendants-Appellants, Cross-Appellees.	)	

This matter comes on for consideration of defendants-appellants, cross-appellees' Citizens Bank of Clovis; Jeff Jacobs; Lynell G. Skarda; Oscar Toliver;

and T. E. Willmon, Jr., petition for rehearing and suggestion for rehearing en banc in the captioned appeals.

Upon consideration whereof, the petition for rehearing is denied by the panel to whom the case was argued and submitted.

The petition for rehearing having been denied by the panel to whom the case was argued and submitted, and no member of the panel nor judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing en banc is denied.

s/s Robert L. Hoecker
ROBERT L. HOECKER, Clerk

*of the United States District Court for the District of Utah, sitting by designation.

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RESTATEMENT OF THE LAW

Second

TRUSTS 2d

Volume 1

Secs. 1-260

As Adopted and Promulgated

BY THE

AMERICAN LAW INSTITUTE

AT WASHINGTON, D. C.

May 23, 1957

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Sec. 228. Distribution of Risk or Loss

Except as otherwise provided by the terms of the trust, the trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so.

See Reporter's Note.

Comment:

a. Duty to diversify investments. The trustee is under a duty to the beneficiary to exercise prudence in diversifying the investments so as to minimize the risk of large losses, and therefore he should not invest a disproportionately large part of the trust in a particular security or type of security. It is not enough that each of the investments is a proper investment under the rule stated in Sec. 227.

b. Factors to be considered. In making a diversification of investments the trustee should consider among others the following factors: (1) the purposes of the trust; (2) the amount of the trust estate; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) the dates of maturity.

c. Where diversification not required. Since the rule stated in this Section is an application of the general rule stated in Sec. 227, there may be special circumstances in which the trustee is excused from diversifying investments. Thus, where the trust estate is very small it may be proper for the trustee to invest the whole or substantially the whole of it in one

security or type of security. If, for example, the trust estate amounts to one or two thousand dollars, it may be proper to invest the whole amount in a single mortgage. So also, in times of crisis and general financial instability, it may be proper to invest a large portion or even the whole of the trust estate in a single type of security such as government securities. In any event the trustee is not liable if under all the circumstances his conduct is that of a prudent man and he complies with the provisions of the terms of the trust and of any statute which may be applicable.

d. Single security. The trustee should not usually invest the whole or an unreasonably large proportion of the trust property in a single security. Illustration:

1. A is trustee for B of $50,000. He invests $25,000 in bonds of the

X Railroad Company. He commits a trust in so doing.

e. Type of security. Ordinarily the trustee should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or one class of enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses. Thus although the trustee may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the trust fund in the shares of corporations engaged in a particular industry. If he is investing in mortgages on real estate he should not invest a disproportionate amount of the trust fund in mortgages in a particular district or upon a particular class of property so that a decline in property

values in that district or of that class might cause a large loss.

f. Terms of the trust. By the terms of the trust the requirement of diversification may be dispensed with. This may be either by a mandatory direction to the trustee to invest the whole or a specified part of the trust property in a particular security or type of security, or by permission to the trustee so to do. In the case of a mandatory direction the trustee is not liable for making investments in accordance therewith, except as provided by Secs. 165-167. In the case of a permission to the trustee, he is not liable for making investments in accordance therewith unless he abuses the discretion conferred upon him by the terms of the trust (see Sec. 187), or fails to act with prudence (see Sec. 227). Illustration:

2. A bequeaths to B $100,000 and

1000 shares of the X Company. By the terms of the will B is authorized to invest the money in the purchase of additional shares of the X Company. B invests $50,000 in the purchase of such shares. In the absence of any further circumstances, B is not liable for breach of trust in making the purchase.

g. Whether the requirement for diversification is dispensed with by the terms of the trust is a question of interpretation. The mere fact that the trustee is authorized to make investments in his discretion does not dispense with the duty to make a reasonable diversification of investments.

h. Extent of liability. If a breach of trust consists only in investing too large an amount in a single security or type of security, the trustee is liable only for such loss as

results from the investment of the excess beyond the amount which it would have been proper so to invest.

Illustration:

3. A is trustee for B of $50,000. He invests $20,000 in bonds of the X Railroad Companyy. Under the circumstances it is not imprudent to invest $5000 in such bonds, but is imprudent to invest more than that amount. X becomes insolvent and the bonds are sold for $10,000. A is liable to B for $7500.

i. Cross reference. As to the duty of the trustee to dispose of investments included in the trust at the time of its creation in order to secure a proper diversification, see Sec. 230, Comment j.